



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PPD 730.5.26

May 23, 2002
02-PPD-044(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Supplemental Audit Guidance on Special Purpose Audits of Contract Overpayments

On November 2, 2001, we issued audit guidance on special audits of contract overpayments and progress payments (MRD 01-PPD-083(R)). As a result of audits performed to date, we determined lessons learned and areas where clarifications to guidance are necessary. This guidance memorandum discusses some of the lessons learned and provides a revised audit program reflecting these lessons.

Reconciliation of Recorded and Billed Costs

During the special purpose audits of overpayments, auditors have found instances of contracts in an overpaid status because recorded (or booked) costs are less than billed costs, and the contractor has not submitted revised billings to refund the overpaid costs. Examples of reasons for reductions in recorded costs on individual contracts include downward adjustments to billing rates, material and labor cost transfers to other contracts, and contract administration adjustments such as settlement of indirect rates and cost accounting noncompliances. Contractors should have adequate billing system procedures in place to ensure that recorded and billed costs are reconciled on a periodic basis on both in-process and physically complete (but not closed) contracts and credit billings are submitted timely when billed costs exceed recorded costs.

CAM 5-1107.4 provides guidance on auditing contractor procedures and controls for reconciling recorded contract costs to billed costs. During the audit of billing systems and the special audits of contract overpayments, auditors must test contractor procedures for reconciling recorded costs to billed costs, including those contracts with no recent billing activity (e.g., physically complete contracts that have not been closed out). The contractor's procedures should provide for prompt adjustments to billings when recorded costs become less than billed costs.

Adjustments to Interim Billing Rates

CAM 5-1107.2 and 6-705.1.d stipulate that auditors should compare billing rates to year-end recorded allowable rates to determine if the billing rates need to be changed. Auditors

should also compare billing rates to rates submitted in the incurred cost proposal and to audit determined or contracting officer negotiated rates when the rates are settled. After billing rates are adjusted, auditors should selectively review paid billings and billing records for physically complete contracts that have not yet been closed to ensure that the correct billing rates are being used and that retroactive adjustments have been made when the billing rates have been adjusted downward.

Adjustments for Credits and Refunds

CAM 6-203.2 provides guidance for audits of contractors' procedures for processing adjustments to billings for credits and refunds. Normally, contractors will make the necessary adjustments to billings after they are notified that billed costs exceed recorded costs. If a contractor does not make the necessary adjustments to billings for credits and refunds, the FAO should issue a DCAA Form 1 on cost type contracts. For other than cost type contracts (or in those instances where it is not feasible to issue a DCAA Form 1), the FAO should notify the contracting officer and paying office of the overpayment using the pro forma memorandum included in Attachment 1 to the enclosed standard audit program.

Revisions to Audit Program

The standard audit program for review of contract overpayments, contract refunds, contract offsets, and contract administration adjustments has been updated to reflect the lessons learned as discussed in this guidance memorandum. The scope and objectives of the audit program have not changed. Rather, to assist the auditor in completing the audit in a more efficient manner, the audit program steps have been organized in separate and distinct sections for the following major audit areas:

- Comparison of billed and paid amounts
- Reconciliation of recorded to billed costs
- Contract administration adjustments
- Demand letters
- Subcontract billings
- Offsets
- Refunds

The revisions to the audit program were briefed in December 2001–January 2002 in a training session to all FAOs performing special purpose overpayment audits.

Field office personnel should direct any questions regarding this memorandum to their Regional DFAS Task Force member. If regional personnel are unable to answer or have

questions of their own, they should contact Mr. Barry Turner, Program Manager, Policy Programs Division at (703) 767-2290.

/signed/ Robert DiMucci
(for)
Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosure:

Revised Standard Audit Program For Review of Contract Overpayments

DISTRIBUTION: C

DEFENSE CONTRACT AUDIT AGENCY

AUDIT PROGRAM FOR REVIEW OF CONTRACT OVERPAYMENTS, CONTRACT REFUNDS, CONTRACT OFFSETS AND CONTRACT ADMINISTRATION ADJUSTMENTS

Contractor's Name: _____

Assignment Number: _____

Field Audit Office: _____

Date Assigned: _____

Auditor Assigned: _____

Supervisor's Signature Indicating Approval
(Obtain Signature Before Starting Evaluation)

A. **PURPOSE AND SCOPE:**

1. Purpose. This audit is intended to ensure that contractors' billing system procedures and internal controls (1) identify contract overpayments, (2) refund or offset amounts due the government in a timely manner, (3) require adequate documentation when offsets are made against billings for previously identified overpayments, (4) identify contract administration adjustments and ensure appropriate refunds or offsets are processed timely as a result of those adjustments, and (5) maintain appropriate oversight over subcontractor billings. In addition, auditors should notify the cognizant contracting officer and paying office of significant overpayments not previously disclosed to the government.

This program is limited to the audit of the internal control policies and procedures outlined in Section E of the audit program. To the extent possible, prior audit effort should be used as a basis for validating the contractor's procedures and internal controls. Before beginning this audit, the auditor should identify any internal control reviews performed by the contractor or its external auditor relating to this audit area. In those cases where internal reviews have been performed, the auditor should follow the guidance contained in CAM 4-1000, Reliance on the Work of Others.

The audit should be conducted in accordance with the auditing standards to the extent applicable under the circumstances. The steps in the program are intended as general guidance and should be modified as necessary to fit the current evaluation. Those steps not required should be deleted or marked "not applicable" (N/A).

2. Scope. The evaluation steps selected for completion, or added as necessary, represent a determination of requirements based on auditor judgment and a clear understanding of the purpose of the audit.

B. DEFINITIONS

1. **Contract Overpayments.** Overpayments are payments that the contractor is/was not entitled to receive. Overpayments usually result from contractor or government errors, including inadvertent erroneous/duplicate billings or payments.
2. **Refunds.** A refund is an overpayment or contract administration adjustment amount that has been returned (refunded) to the government by the contractor.
3. **Contract Administration Adjustments.** Contract administration adjustments include payments which the contractor received in accordance with contract provisions but which need to be reduced as a result of subsequent events or actions. Contract administration adjustments may result from contract administration related actions, such as progress payment adjustments due to a contract loss position, changes in contract billing prices, changes in liquidation rates, changes in foreign exchange rates, quarterly limitation of payment adjustments, government withholds as a result of contract performance problems; and settlement of final indirect rates, cost accounting standard noncompliances, or postaward review audits.
4. **Offsets.** An offset is a reduction of an overpayment amount (an amount owed the government by the contractor) on an unpaid or underpaid invoice submitted to the paying office. An offset is a means of satisfying a debt owed by the contractor to the government without issuing a refund check to the government.

C. REFERENCES:

1. Standard Audit Program APBILL - Audit Step G.2.n (Comparison of amounts billed to amounts received).
2. Standard Audit Program APBILL - Audit Step G.3.i (Selected review of comparison of amounts billed to amounts received).
3. CAM 5-1100, Section 11 – Audit of Billing System Internal Controls
4. CAM 6-203 – Credits and Refunds on Cost-Type Contracts
5. CAM 6-705 – Interim Cost-Reimbursable Billings
6. CAM 6-1000, Section 10 – Responsibilities for Processing and Approval of Interim and Completion Cost-Reimbursable Vouchers

D Preliminary Audit Steps

1. Conduct an entrance conference as outlined in CAM 4-302, with particular emphasis on the following areas:

- a. Purpose of Audit. Explain to the contractor that this audit is intended to verify that contractors have in place effective internal controls and billing procedures to assure timely identification and resolution of contract overpayments, contract administration adjustments, demand letters, and subcontractor overpayments.
- b. Comparison of Billed and Paid Amounts. Request the contractor to explain and to provide a copy of its procedures for comparing amounts billed to amounts received at the invoice level and the process for resolving payment variances (including notifying the government when overpayments are identified and returning the overpayments). Request the contractor to provide a listing of all payment variances for the most current 12-month period available. Also request the contractor to provide a listing of all outstanding payment variances, including those that are over 12 months old. Also request the contractor to provide the accounts receivable aging report and the accounts payable aging report, showing the payment status of the contracts.
- c. Reconciliation of Recorded to Billed Costs. Request the contractor to explain and to provide a copy of its procedures for performing the periodic reconciliation of recorded to billed costs. Also request the contractor to provide the reconciliation of recorded and billed costs for all significant contracts (including physically complete contracts awaiting closeout with no recent billing activity).
- d. Contract Administration Adjustments. Request the contractor to explain and to provide a copy of its procedures for processing contract

administration adjustments. Request a listing of contract administration adjustments processed over the last 12 months.

- e. Demand Letters. Request the contractor to explain and to provide a copy of its procedures for processing government demand letters for payments. Request the contractor to provide a listing of demand letters processed over the last 12 months.
 - f. Subcontract Billings. Request the contractor to explain and to provide a copy of its procedures for monitoring subcontractor billings. Request the contractor to provide a list of the top 3-5 subcontractors (dollars in billings) that submit billings under prime or upper tier contracts.
 - g. Offsets. Request the contractor to explain and to provide a copy of its procedures for processing offsets (i.e., offsetting overpayments against unpaid or underpaid invoices at the paying office). Request a listing of all offsets processed over the last 12 months. Request a listing of the payment status of all significant contracts (i.e., listing showing if the contract is in a net over or underpaid status).
 - h. Refunds. Request the contractor to explain and to provide a copy of its procedures for processing refunds to government paying offices. Request the contractor to provide a listing of refunds processed over the last 12 months.
2. Evaluate permanent files (including previous assessments of the accounting and billing internal control systems and control risk summarized on the ICAPS sheets and audit leads) and prior audits to determine what relevant audit effort has been performed relating to the detailed audit steps described in Section E below.

E Detailed Audit Steps

1. Comparison of Billed and Paid Amounts.

- a. Review the contractor's written policy and procedures and assess their adequacy regarding the identification and resolution of contract overpayments. The contractor should:
 - (1) perform comparisons of amounts received to amounts billed at the invoice level (e.g., for each public voucher, progress payment request, and delivery invoice) to readily identify contract overpayments,
 - (2) document timely notification of overpayments to the contracting officer and paying office,
 - (3) document significant activities during the resolution process (e.g., e-mails, conversations, meetings, etc.),
 - (4) document compliance with contracting officer and paying office instructions to resolve overpayments, and
 - (5) resolve overpayments within 30 days after the overpayment had been made.
- b. Compare contracts on the accounts receivable aging report and the accounts payment aging report to the contracts on the list of overpayments to ensure outstanding accounts receivable and accounts payable are included in the list of overpayments. For contracts not included in the overpayment list, include the contracts in the universe of overpayments for sampling in step c. below.
- c. Selectively review contractor comparisons of amounts received to amounts billed and other contractor documentation to determine if the list of payment variances is accurate and complete. Select a sample of overpayments (from the list of

payment variances identified during the last 12 months and the list of current outstanding overpayments) to determine:

- (1) the reason(s) for the overpayment,
 - (2) whether the contractor can document its notification to the contracting officer and paying office of the overpayment within 30 days of occurrence,
 - (3) the reason for any failure to notify the contracting office or paying office of differences,
 - (4) whether overpayments were returned within 30 days of the overpayments, and
 - (5) the reason for any failure to return overpayments in a timely manner.
- d. Immediately notify the paying office via memorandum if a significant contractor overpayment is disclosed during the audit and (1) the contractor has not notified the government, and (2) the overpayment is over 30 days old and has not been returned. Use the pro forma memorandum at Attachment 1 to make this notification.

2. Reconciliation of Recorded to Billed Costs.

- a. Review the adequacy of the contractor's policy and procedures for reconciling recorded to billed costs. Contractors should have adequate procedures in place to ensure that recorded and billed costs are reconciled on a periodic basis on both in-process and physically complete (but not closed) contracts and credit billings are submitted timely when billed costs exceed recorded costs. Examples of reasons for reductions in recorded costs on individual contracts include downward adjustments to billing rates (see CAM 6-705.1.d), material and labor cost transfers to other contracts, and contract administration adjustments such as

settlement of indirect rates and cost accounting noncompliances.

- b. Review the contractor's reconciliation of recorded to billed costs to verify it includes all significant contracts (including all physically completed contracts with no recent billing activity). Determine that the calculation of recorded costs (for this comparison purpose) is based on acceptable rates.
- c. For any contract where billed costs exceed recorded costs, request the contractor to process credit billings. If the contractor does not make adjustments to billings to reflect allowable recorded costs, the FAO should issue a DCAA Form 1 on cost type contracts. For other than cost type contracts (or in those instances where it is not feasible to issue a DCAA Form 1), the FAO should notify the contracting officer and paying office of the overpayment using the attached pro forma memorandum.

3. Contract Administration Adjustments.

- a. Review the adequacy of the contractor's policy and procedures for processing contract administration adjustments. Contractors should have adequate procedures to ensure that the impacts of contract administration adjustments are reflected in billings or refunds within 30 days of the date of the administration adjustment (e.g., contract modification or settlement of indirect rates). Interview both contract and billing department personnel and review the procedures in both departments to determine if contract administration adjustments are being adequately identified, monitored, and reflected timely in billings or refunds.
- b. Verify that the schedule of contract administration adjustments is complete. This verification will require the review of documentation in the contractor's contracts and billing department. Obtain the contracting

officer's comments on the completeness and accuracy of the schedule.

- c. Select a sample of significant contract administration adjustments to determine if the adjustment was computed accurately and that a refund or offset was processed within 30 days of the date of the administration adjustment.
- d. If the contractor's procedures for processing contract administration adjustments are not adequate, consider reviewing contract modifications on the top 3-5 contracts for the last 12 months to identify any contract administration adjustments that should have been processed.
- e. Immediately notify the paying office and contracting officer of any outstanding contract administration adjustment over 30 days old where a refund or offset has not been processed. Use the proforma memorandum at Attachment 1 to make this notification.

4. Demand Letters.

- a. Review the adequacy of the contractor's policy and procedures for processing government demand letters for payment. The contractor's procedures should ensure that demand letters are identified and monitored, and that refunds or offsets are processed within 30 days of the date of the demand letter. If the contractor disputes the demand letter, the contractor should submit documentation supporting the dispute to the paying office within 30 days after the date of the demand letter.
- b. Verify that the listing of demand letters is complete. Consider coordinating with the Regional DFAS Task Force member to obtain a listing of demand letters for the contractor from the paying office. Also, verify the completeness of the listing with the contracting officer.

- c. Select a sample of significant demand letters issued during the last 12 months to determine if the contractor processed a refund or offset in a timely manner. For any significant disputed debts, review the adequacy of the contractor's documentation for the support, and verify that this documentation was submitted to the paying office within 30 days of the demand letter.
- d. Immediately notify the paying office and contracting officer of any demand letter that is over 30 days and has not been processed. Also, notify the paying office and contracting officer of any disputed debt not supported by the contractor or where documentation has not been submitted to the paying office. Use the pro forma memorandum at Attachment 1 to make this notification.

5. Subcontract Billings.

- a. Review the adequacy of the contractor's policy and procedures for monitoring subcontract billings to identify, document, and resolve subcontractor overpayments, contract administration adjustments, offsets, and refunds. The prime contractor FAO should contact the FAO of the subcontractor to obtain information on the subcontractor's billing system. The contractor's procedures should ensure that:
 - (1) subcontractor's have adequate accounting and billing systems,
 - (2) the subcontractor notifies the contractor of overpayments and required refunds as a result of contract administration adjustments,
 - (3) the contractor notifies the subcontractor of any contract administration adjustment impacting the subcontractor's billings and that timely refunds or offsets are processed,

- (4) the subcontractor notifies the contractor and obtains approval prior to processing any offsets,
 - (5) the contractor performs periodic reconciliations of subcontractor billed and paid amounts, and
 - (6) the contractor timely adjusts its billings or submits refunds for identified subcontractor overpayments, contract administration adjustments, offsets, and refunds.
- b. Select a sample of subcontractor billings for the top 3-5 subcontractors (dollars in billings) to verify that the above procedures are being accomplished.
- c. Immediately notify the paying office of any subcontractor overpayment, contract administration adjustment, offset or refund that the contractor has not reflected in billings or refunds to the paying office. Use the pro forma memorandum at Attachment 1 to make this notification.

6. Offsets.

- a. Review the adequacy of the contractor's policy and procedures for processing offsets. The contractor's procedures should ensure that:
 - (1) significant offsets of overpayments and contract administration adjustments are made only after notification to and instruction from the contracting officer and paying office (and the contractor maintains adequate documentation of this coordination),
 - (2) offsets are made on a timely basis, usually within 30 days of identification of the

overpayment or contract administration adjustment,

- (3) offsets are only processed on the same contract where the overpayment or contract administration adjustment occurred,
 - (4) offsets are only processed on unpaid or underpaid invoices already submitted to the paying office,
 - (5) the contract does not remain in an overpaid status after the offset is processed, and
 - (6) adequate accounting records are maintained to show all offsets and the overpayment/underpayment status for all in-process and physically completed contracts.
- b. Verify that the listing of offset activity for the last 12 months includes all significant offsets. Sample significant offsets and determine if they meet the 6 criteria for allowable offsets discussed in a. above. Verify that the offsets represent offsets already identified during the review of billed and paid amounts, reconciliation of recorded and billed costs, contract administration adjustments, demand letters, and subcontract billings. If additional items are found during the review of offsets, request the contractor to explain why the items were not included on the schedules provided for each of the areas. Perform additional audit work to verify that the schedules discussed in Detailed Steps E.2 – E.5 above are complete.
- c. Verify that the schedule of the payment status of contracts includes all significant contracts (including both in-process and physically complete, but not closed). Review the schedule to identify all contracts that are in a significant overpaid status.
- d. Immediately notify the paying office of any offsets that do not meet the 6 criteria using the

pro forma memorandum in Attachment 1 to make this notification.

7. Refunds.

- a. Verify the completeness of the list of refunds to government paying offices for the last 12 months by selectively comparing the list to checks issued to the paying offices.
- b. Select a sample of significant refunds to determine the reasons for the refunds. The refunds should represent refunds already identified during the review of billed and paid amounts, reconciliation of recorded and billed costs, contract administration adjustments, demand letters, and subcontract billings. If additional items are found during the review of refunds, request the contractor to explain why the items were not included on the schedules provided for each of the areas. Perform additional audit work to verify that the schedules discussed in Detailed Steps E.2 – E.5 above are complete.

F Summary Audit Steps

1. Discuss the results of audit with Supervisory Auditor and perform any other audit effort required.
2. Conduct an exit conference with the contractor in accordance with CAM 4-304.
3. Prepare a memorandum for the record to document the audit results, the key audit procedures applied, and the significant data reviewed. A pro forma memorandum for the record is included as an Attachment. If significant deficiencies are found, note them in the MFR and consider the effect of the deficiencies on the scope and timing of the next contractor billing system audit. Consider issuing a flash internal control deficiency report to facilitate prompt contractor correction of the billing system deficiencies. A copy of the MFR should be provided

to Headquarters, Attention: PPD (email – dcaa-ppd@dcaa.mil).

4. Ensure that the paying office has been notified of any unresolved overpayments, contract administration adjustments, demand letters, and subcontract billings that are over 30 days old; and of any improper offsets. The pro forma memorandum is included as Attachment 1. The memorandum should be sent to the paying office (joanne.robbins@dfas.mil) with a copy to the ACO and Headquarters, Attention: PPD (email – dcaa-ppd@dcaa.mil).
5. Update the permanent file in accordance with CAM 4-405.1b (MAAR #3).
6. Closing actions should be performed in accordance with FAO procedures. These procedures may require either auditors or administrative personnel to perform various closing steps. Completion of these closing actions should be documented in the working papers.

TOTAL HOURS

XXXX

MEMORANDUM FOR DEFENSE FINANCE AND ACCOUNTING SERVICE, COLUMBUS
CENTER, 4280 EAST 5TH AVENUE, COLUMBUS, OHIO 43219-
1879

ATTENTION: Reconciliation Directorate, Joanne Robbins

SUBJECT: Unresolved Contract Payment Issues at *[Name of Contractor]*

A recent DCAA audit of contract payments at *[Name of Contractor]* disclosed the following unresolved payment issues. We are bringing these issues to your attention so that you may take whatever actions you deem necessary.

Overpayments That Have Not Yet Been Returned by the Contractor

[To the extent known, provide the following information regarding each unreturned overpayment:

- *Amount of overpayment*
- *Date overpayment occurred*
- *Contract number*
- *Contractor voucher or other billing number*
- *Date contractor advised ACO and/or paying office of overpayment, if applicable*
- *Person(s) whom the contractor advised of overpayment*
- *Repayment instructions, if any, provided to the contractor by the government*
- *Details on the causes of the overpayment*
- *Reason that the contractor has not refunded the overpayment*
- *Contractor identification:*
 - *Address*
 - *Contractor point of contact and telephone number*
 - *CAGE Code*
 - *Taxpayer Identification Number*
- *Any other relevant information]*

Improper Offsets of Overpayments by the Contractor

[To the extent known, provide the following information regarding each improper offset:

- *Amount of overpayment being offset*
- *Date offset occurred*
- *Contract number*
- *Contractor voucher or other billing number*
- *Date contractor advised ACO and/or paying office of overpayment and offset, if applicable*
- *Person(s) whom the contractor advised of overpayment and offset*
- *Offset instructions, if any, provided to the contractor by the government*

- *Details on the causes of the overpayment*
- *Reason that the contractor offset the overpayment*
- *Contractor identification*
 - *Address*
 - *Contractor point of contact and telephone number*
 - *CAGE Code*
 - *Taxpayer Identification Number*
- *Any other relevant information]*

Contract Administration Adjustments That Have Not Yet Been Returned by the Contractor

[To the extent known, provide the following information regarding each unreturned contract administration adjustment:

- *Amount of overpayment/refund*
- *Date of contract administration adjustment*
- *Contract number*
- *Date contractor advised ACO and/or paying office of the contract administration adjustment, if applicable*
- *Person(s) whom the contractor advised of the contract administration adjustment*
- *Repayment instructions, if any, provided to the contractor by the government*
- *Details on the causes of the contract administration adjustment*
- *Reason that the contractor has not refunded the contract administration adjustment*
- *Contractor identification:*
 - *Address*
 - *Contractor point of contact and telephone number*
 - *CAGE Code*
 - *Taxpayer Identification Number*
- *Any other relevant information]*

Demand Letters Over 30 Days Old That Have Not Been Returned by the Contractor

[To the extent known, provide the following information regarding each demand letter not yet processed by the contractor:

- *Amount of demand letter*
- *Date of demand letter*
- *Contract number*
- *Details on the reasons for the demand letter*
- *Reason that the contractor has not refunded the demand letter amount*
- *Contractor identification:*
 - *Address*
 - *Contractor point of contact and telephone number*
 - *CAGE Code*
 - *Taxpayer Identification Number*

- *Recommendations to the payment office on demand letter amount; e.g., demand letter is valid and the debt should be offset on the next contractor billing submitted to the payment office.*
- *Any other relevant information]*

Subcontract Overpayments That Have Not Yet Been Returned by the Contractor

[To the extent known, provide the following information regarding each unreturned overpayment:

- *Amount of overpayment*
- *Date overpayment occurred*
- *Contract number*
- *Contractor voucher or other billing number*
- *Date contractor advised ACO and/or paying office of overpayment, if applicable*
- *Person(s) whom the contractor advised of overpayment*
- *Repayment instructions, if any, provided to the contractor by the government*
- *Details on the causes of the subcontract overpayment*
- *Reason that the contractor has not refunded the overpayment*
- *Contractor identification:*
 - *Address*
 - *Contractor point of contact and telephone number*
 - *CAGE Code*
 - *Taxpayer Identification Number*
- *Any other relevant information]*

We will be pleased to provide any additional information or auditing services that may be required. Inquiries may be directed to *[Name of DCAA contact]* at *[telephone number]* or e-mail at *[e-mail address]*.

[FAO Manager Name]
FAO Manager

Copy Furnished
ACO
Headquarters (Attn: PPD)



IN REPLY REFER TO
3XXX/XXX
(2002A17310001)

DEFENSE CONTRACT AUDIT AGENCY
CENTRAL REGION
ABC COMPANY RESIDENT OFFICE
123 NEW ROAD
ANY TOWN, USA

(Insert Date)

MEMORANDUM FOR RECORD

SUBJECT: Audit of Contract Overpayments, Contract Administration Adjustments, Contract Refunds, Contract Offset Documentation, Demand Letters, and Subcontract Billings

Audit Objectives:

As part of our comprehensive audit of the ABC Company (ABC), we performed an examination of ABC's billing system internal controls related to overpayments, contract administration adjustments, demand letters, subcontract billings, contract offset documentation, and contract refunds. The purpose of the audit was to determine if adequate billing internal controls and procedures exist to:

- Compare billings with cash receipts to identify overpayments at the invoice level (e.g., public vouchers, progress payment requests, and delivery and final invoices);
- Reconcile billed and booked costs on a periodic basis on in-process and physically complete (but not closed) contracts and prepare revised billings when booked costs become less than billed costs (e.g., contract administration adjustments such as indirect rate adjustments, material and labor cost transfers, cost accounting standard noncompliance settlements, etc.);
- Ensure timely action is taken to resolve overpayments (the government paying office and contracting officer, are notified timely and refunds or offsets are processed within 30 days);
- Ensure that contract administration adjustments (e.g., contract modifications) impacting billings are processed timely and refunds/offsets are processed within 30 days after date of contract modification;
- Ensure timely and documented responses and/or refunds or offsets are prepared in response to demand letters issued by the contracting officer or paying office;
- Monitor subcontractors' billings to ensure that (i) subcontractors have adequate accounting and billing systems, (ii) the subcontractor notifies the contractor of overpayments and required refunds as a result of contract administration adjustments, (iii) the contractor notifies the subcontractor of any contract administration adjustments impacting the subcontractor's billings and that timely refunds or offsets are processed, (iv) the subcontractor notifies the contractor and obtains approval prior to processing any

offsets, (v) the contractor performs periodic reconciliations of subcontractor billed and paid amounts, and (vi) the contractor timely adjusts its billings or submits refunds for identified subcontractor overpayments, contract administration adjustments, offsets, and refunds;

- Ensure adequate documentation is prepared and maintained for any reduction of current requests for payment (contract offsets) on contract billings for amounts owed the government (i.e., the government is notified before any offset is processed, offsets are only processed on the same contract, and adequate records are maintained by contract to show the offsets and the net payment status), and the contract is not in an overpaid condition after the offset is processed.

We reviewed contractor documents and records related to its billing system and related internal controls, including:

- accounts receivable aging reports,
- accounts payable aging reports,
- payment variance accounts showing results of the comparisons between billed amounts and cash receipts,
- reconciliations of billed and booked costs,
- reports showing the payment status of all significant contracts,
- reports listing refunds made to the government,
- individual billings and checks submitted to the government,
- contract offset reports,
- reports showing the status of contract administration adjustments and the computations of those adjustments,
- contract modifications and other source documentation relating to contract administration adjustments,
- demand letters,
- contractor status reports on demand letters and the responses to demand letters, and
- subcontract administration reports and documentation.

Background Information

ABC Company's annual total sales (*or total sales for latest fiscal year*) are approximately \$XXX million, including \$XXX of DoD sales and \$XXX of government sales. The contractor's fiscal year (FY) 2002 ADV is approximately \$XXX million. Billings on DoD contracts for the period XX to XXX, 2001, (*12 month period of detailed examination of internal controls*) were \$XXX, including \$XX on progress payments/delivery invoices, \$XX on public vouchers (cost-type), and \$XX of other billings (*describe if significant*).

The contractor's primary product lines are XXXXX (*describe top 3-5*). Its major government customers are XXX (*describe top 3-5*).

Audit Results:

Comparison of Billed and Paid Amounts

During the period XXX to XXX, 2001 (*12 month period of review of comparisons of billed and paid amounts*), the contractor identified XX overpayments totaling over \$XXX million. We also obtained the contractor's schedule showing all outstanding overpayments, including those that were identified before the 12 month period and are still outstanding. The contractor has adequate procedures for comparing billings with cash receipts. ABC Company identified the overpayments by (*describe contractor's comparison process, e.g., ABC compares billed amounts to cash receipts at the invoice level. All payment variances are identified and reported in the contractor's Contract Payment Variance Report until resolved*).

The contractor does not have adequate procedures for resolving payment variances in a timely manner. We sampled all overpayments over \$XX to examine the contractor's procedures for identifying and resolving overpayments. Our sample included XX overpayments totaling over \$XXX million. Our examination found that XX overpayments totaling \$XX million have not been refunded either by check or offset. For those overpayments that have been refunded or offset during the period of our detailed examination, (*identify 12 month period used*), we found that the contractor takes an average of about XX days to issue refunds and about XX days to resolve using offset procedures. (*Note that a range may be more appropriate where there is a significant difference, e.g. one refund of \$XXX took 400 days to process and the remaining refunds totaling \$XXX took XX to XX days to process.*)

Attachment 1 includes details on the XX overpayments that are outstanding over 30 days and are still outstanding as of (*date of most recent available data*). (*Attach schedule showing the details for each overpayment – overpayment amount, overpayment date, reason for the overpayment, whether the contract is in a net overpaid or underpaid position, etc.*).

We issued memorandums to the Defense Finance and Accounting Service (DFAS) providing details on each of the overpayments still outstanding over 30 days for the purpose of assisting DFAS in collecting the overpayments. (*If memorandums were not issued to DFAS explain why.*) The contractor needs to establish procedures and internal controls to ensure that overpayments are resolved within 30 days after receipt of the overpayment.

Reconciliation of Recorded to Billed Costs

The contractor's procedures for reconciling recorded costs to billed costs need improvement. The contractor does not periodically reconcile recorded and billed costs on physically complete (but not yet closed) contracts. We identified XX contracts that were overpaid by \$XXX,XXX because the contractor did not reconcile recorded and billed costs to identify contracts that were in an overpaid status as a result of downward adjustment to recorded costs (e.g., contract administration adjustments such as indirect rate adjustments, material and labor cost transfers, cost accounting standard noncompliance settlements, etc.). Attachment 2 lists the contracts that are in an overpaid status because billed costs are greater than recorded

costs. We coordinated with the contractor and the contracting officer to get the contractor to submit revised billings to return the overpayments. As of *(Date)*, all revised billings for these contracts have been processed.

The contractor needs to establish procedures and internal controls ensuring that reconciliations of billed and recorded costs are performed on a periodic basis for all contracts (including physically complete contracts awaiting closeout); and revised billings are submitted when billed costs exceed recorded costs.

Contract Administration Adjustments

The contractor's procedures for processing and documenting contract administration adjustments need improvement. (Briefly describe the contractor's procedures for processing contract administration adjustments, e.g., the contractor's contracts department maintains a log of all contract modifications that impact billings and monitors those modifications until refunds or additional billings have been prepared to disposition the modification.). During the period XXX to XXX, 2001 *(12 month period of review of contract administration adjustments)*, we found that the contractor took an average of over XX days to process contract administration adjustments. We also found that the contractor took over a year to process X contract administration adjustments that resulted in over \$XX million of refunds or offsets to the government. As of *(date of most recent available data)*, the contractor has not processed X contract administration adjustments that will result in estimated refunds or offsets to the government of over \$XX million. The contract modifications for these outstanding adjustments range in age from X months to over X years.

The primary reasons for the contract administration adjustments on these contracts are *(identify Top 3-5 reasons and explain whether the contract is in a net overpaid or underpaid position after the contract administration adjustment was processed)*. Attachment 3 includes details on the outstanding contract administration adjustments *(attach schedule showing the details for each outstanding adjustment – the estimated refund/offset amount, the date of the contract modification, the period of time the adjustment has been outstanding, the reason for the adjustment, etc.)*

We issued memorandums to DFAS providing details on each of these contract administration adjustments to assist DFAS in collecting the refunds or processing the offsets. *(If memorandums were not issued to DFAS explain why.)* The contractor needs to establish procedures and internal controls ensuring that contract administration adjustments are processed within 30 days after the date of the contract modification.

Demand Letters

The contractor's procedures for processing demand letters for payment need improvement. During the period XXX to XXX, 2001 *(12 month period of review of demand*

letters), the contractor received XX demand letters from DFAS and the contracting officer demanding payment of \$XX million. The contractor responded to X of the demand letters on the average of XX days after receipt of the letter and provided \$XX million of payments. The contractor has not yet responded to X of the demand letters requesting payments of \$XX million. These demand letters were dated X to X months ago. Attachment 4 includes details on the demand letters that are currently outstanding (*attach schedule showing details on the outstanding demand letters – date of letter, period outstanding, demand letter amount, reason for the demand letter, etc.*)

We issued memorandums to DFAS providing details on the payment issues described in the demand letters for the purpose of assisting DFAS in resolving the payments. The contractor needs to establish procedures and internal controls to ensure that demand letters are responded to (and include required payments of any undisputed amounts) within 30 days after the letters are received.

Subcontractor Billings

The contractor's procedures for monitoring subcontractor billings need improvement. During the period XXX to XXX, 2001 (*12 month period of review of subcontractor billings*), we found that XX contract administration adjustments impacted subcontractor billings. These adjustments required the subcontractors to return \$XX million to the contractor, who, in turn, should refund this money to the government.

As of (*date of most recent available data*), the contractor has not required X subcontractors to return \$XX million of the \$XX million. We issued memorandums to DFAS providing details on each of these contract administration adjustments for the purpose of assisting DFAS in collecting the outstanding \$XX million. Attachment 5 includes details on these X contract administration adjustments that have not been processed.

The contractor also does not have procedures to compare subcontractor billings to payments. Our examination found that X subcontractors have been overpaid by \$XX million. These overpayments were included, by the prime contractor, in billings to the government. Attachment 6 includes details on these subcontractor overpayments that have not been processed. We also issued memorandums to DFAS providing details on each of these subcontractor overpayments for the purpose of assisting DFAS in collecting the \$XX million.

The contractor needs to establish procedures and internal controls ensuring that contract administration adjustments impacting subcontractor billings are processed timely, and that comparisons of subcontractor billings and payments are performed to provide for timely resolution of subcontractor overpayments.

Offsets

The contractor's procedures for processing offsets need improvement. During the period XXX to XXX, 2001 (*12 month period of review of offsets*), we found that the contractor processed XX contract offset adjustments totaling over \$XX million by reducing current requests

for payment on contract billings without obtaining and/or documenting prior approval from DFAS or the contracting officer. Attachment 7 includes details for each of the offsets that lacked adequate documentation and prior approval (*attach schedule showing the details of the offsets – dates of the offsets, offset amount, reason for the offset, why documentation was considered inadequate, etc.*).

We issued memorandums to DFAS providing details on each of these offsets for the purpose of assisting DFAS in determining if the offsets were proper. (*If memorandums were not issued to DFAS explain why.*)

As of (*date of most recent available data*), we found that XX contracts remained in an overpaid status after the offsets were processed. The total amount of overpayments was over \$XX million on these XX contracts. Attachment 8 contains a schedule of contracts that are still in an overpaid status after the offsets were processed. We issued memorandums to DFAS providing details on each of these overpaid contracts for the purpose of assisting DFAS in collecting the overpayments. (*If memorandums were not issued to DFAS explain why.*)

The contractor needs to ensure that prior approval is obtained before making any contract offsets, and that adequate documentation is maintained on all contract offsets. The contractor also needs to ensure that if contracts remain in an overpaid situation after authorized offsets are processed, that payments are made, in a timely manner, to the government of any remaining balance due.

Refunds

During the period XXX to XXX, 2001 (*12 month period of review of refunds*), we found that the contractor processed XX refunds to government paying offices totaling over \$XX million. We reconciled the 12 month refund data to the refunds identified during the review of billed and paid amounts, reconciliation of recorded and billed costs, contract administration adjustments, demand letters, and subcontract billings. The primary reasons for the refunds are (*identify the top 3-5 reasons for refunds and the related dollar amounts*).

GAO Over/Under Payment Survey (This section is only applicable to those contractors that submitted a completed survey in response to the GAO request for information on outstanding over and under payments)

In October 2001, ABC Company was requested by the U. S. General Accounting Office (GAO) to complete a survey of over/under payments. As part of that survey, ABC identified gross overpayments of \$XXX, gross underpayments of \$XXX, and gross billings to the DoD of \$XXX, as of September 30, 2001. We reconciled the gross overpayment amount to (*describe verification procedures, e.g., to the contractor's Account XXXX, Potential Refunds and to the contractor's quarterly notifications to the administrative contracting officer*). We reconciled the gross underpayment amount to (*describe procedures, e.g., to the contractor's accounts receivable aging report.*) We verified the gross billings amounts by (*describe how billings were verified*). (*Also describe any differences between the over/under payments reported in the survey*)

and the amounts found during the audit at the date of the survey Provide status on any overpayments reported to the GAO that are still outstanding.)

On XXX, we issued an internal control deficiency report describing the above conditions and providing recommendations to improve the billing procedures and related internal controls. *(Or explain that a report will be issued, or that a flash report was issued and will be followed by a complete billing system audit.)* The contractor stated the recommendations will be implemented by XXX, 2002. During the course of our examination, we also noted other matters involving ABC's billing system internal controls related to *(describe specific area, e.g., over/under payments and associated refunds/offsets, contract offset documentation, etc.)* which we communicated to the management of ABC. These "Suggestions to Improve the System" were included on page XX of the internal control audit report. We will follow-up on the contractor's corrective actions within 90 days.

We discussed the results of our audit with Mr. John Doe, ABC Company Controller, in an exit conference held on XXXX XX, 200X. The contractor concurs with the audit results and agrees to develop corrective actions addressing the deficiencies and suggestions for improvement. The contractor's formal written reactions were submitted in response to our internal control deficiency report issued XXXX XX, 200X.

Resident Auditor
ABC Company Resident Office

Attachments:

1. Schedule of Overpayments
2. Schedule of Contracts with Billed Costs Greater Than Recorded Costs
3. Schedule of Outstanding Contract Administration Adjustments
4. Schedule of Demand Letters
5. Schedule of Outstanding Subcontractor Contract Administration Adjustments
6. Schedule of Unresolved Subcontractor Overpayments
7. Schedule of Offsets Without Adequate Documentation/Approval
8. Schedule of Contracts in an Overpaid Status After Offsets